

Bharat Forge

STOCK INFO.	BLOOMBERG
BSE Sensex: 9,311	BHFC IN
	REUTERS CODE
S&P CNX: 2,833	BFRG.BO

16 January 2006

Buy
Rs392
Previous Recommendation: Buy

Equity Shares (m)	197.8
52-Week Range (Rs)	407/204
1,6,12 Rel.Perf.(%)	2/-2/26
M.Cap. (Rs b)	77.5
M.Cap. (US\$ b)	1.8

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
3/05A	12,191	1,616	8.2	29.4	48.0	17.5	36.5	30.0	6.6	24.8
3/06E	15,972	2,212	11.2	36.8	43.8	12.3	35.0	29.5	4.8	18.8
3/07E	20,118	2,928	14.8	32.4	33.1	8.6	32.5	29.9	3.7	14.4

Standalone, P/E on diluted basis

- 3QFY06 results are below our expectations at the operating profit level. YoY, revenues of Bharat Forge grew 29%, EBITDA is up 12.7% and PAT is up 29% at Rs533m.
- The 29% revenue growth to Rs4b was driven by 49% YoY increase in domestic sales. EBITDA margin was at 24.7% compared with 28.2% in 3QFY05 due to higher raw material costs and other expenses.
- On a consolidated basis, total revenues grew QoQ by 37% to Rs9.6b and PAT by 2% to Rs626m. Consolidated EBITDA margins stood at 16.1%. For 9MFY06 EBITDA margins are at 18.6%, in line with our expectations.
- BFL entered into a JV (51:49) with FAW Corporation of China to manufacture a wide range of highly engineered forged auto components. This JV will likely catapult BFL to become the largest forging components player in China.
- After setting up its dual shore model, BFL is successfully leveraging its capability and has recently concluded long-term contracts with three global OEMs for supply of machined power-train components. BFL trades at a P/E of 25x FY07E and 20.9x FY08E on fully diluted consolidated earnings. Given the bright prospects, high growth visibility and clear road map for future growth, we maintain a **Buy** on the stock.

QUARTERLY PERFORMANCE

(Rs Million)

	FY 05				FY 06				FY 05	FY 06E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Domestic Sales	1,614	1,790	1,615	2,068	2094	2,259	2,406	2,626	7,086	9,384
<i>Change (%)</i>	51.6	48.7	27.0	42.6	29.7	26.2	49.0	26.9	42.0	32.4
Exports	954	1,112	1,494	1,544	1542	1,507	1,589	1,951	5,105	6,588
<i>Change (%)</i>	19.8	33.4	76.1	81.3	61.5	35.6	6.3	26.3	53.3	29.1
Net Sales	2,568	2,902	3,109	3,613	3635	3,766	3,994	4,577	12,191	15,972
<i>Change (%)</i>	38.0	42.4	46.6	56.9	41.6	29.8	28.5	26.7	46.5	31.0
Total Expenses	1,878	2,091	2,233	2,715	2,750	2,795	3,008	3,363	8,917	11,915
EBITDA	690	810	875	898	885	971	986	1,214	3,274	4,057
<i>As % of Sales</i>	26.9	27.9	28.2	24.9	24.4	25.8	24.7	26.5	26.9	25.4
<i>Change (%)</i>	26.7	38.0	32.1	48.0	28.2	19.9	12.7	35.2	36.3	23.9
Other Income	42	7	4	21	112	115	161	65	74	451
Interest	79	83	90	91	112	128	153	123	342	516
Depreciation	123	132	136	135	149	175	191	200	526	716
PBT	530	603	654	693	736	783	802	956	2,480	3,277
Tax	190	225	240	210	247	265	270	284	865	1,065
<i>Effective Tax Rate (%)</i>	35.9	37.2	36.7	30.3	33.5	33.8	33.6	29.7	34.9	32.5
PAT	340	378	414	483	489	518	533	672	1,616	2,212
Adj. PAT	340	378	414	483	489	518	533	672	1,616	2,212
<i>Change (%)</i>	29.4	28.9	25.4	33.4	43.9	36.8	28.6	39.1	29.4	36.9

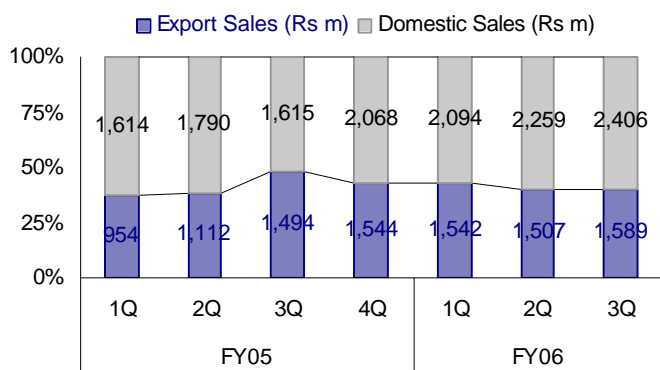
E: MOST Estimates

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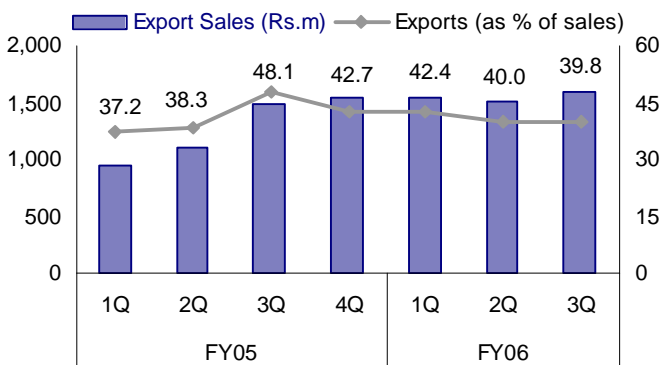
Export momentum slows down in 3QFY06

BFL has recently commissioned its newly expanded plant through which most of the export orders will be executed. In accordance with OEM requirements, components manufactured in the new plant must be routed through a validation and testing cycle. Hence exports in 3QFY06 were lower than expectation. We expect the strong sales momentum to continue and exports to register robust growth in forthcoming quarters.

COMPOSITION OF SALES



SHARE OF EXPORTS IN TOTAL SALES MIX



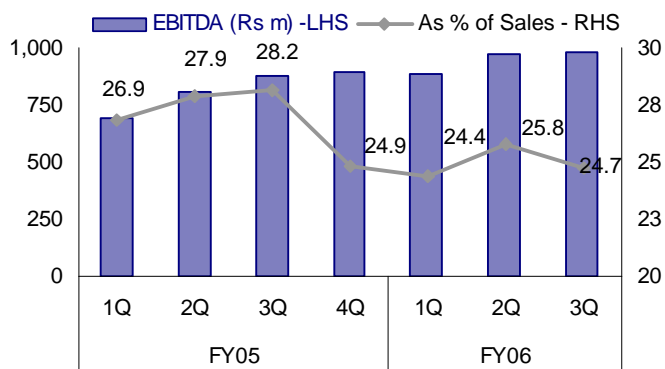
Source: Company/Motilal Oswal Securities

Operating performance under pressure

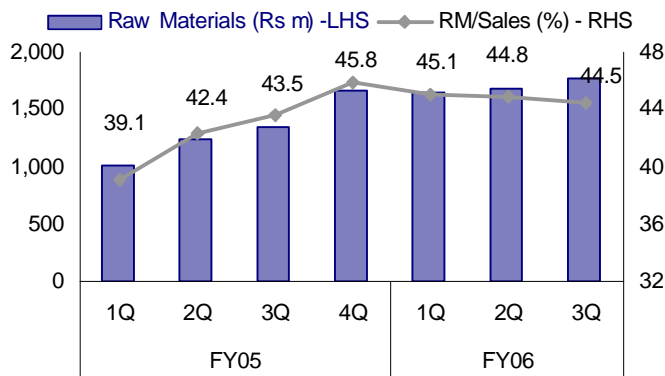
In 3QFY06, Operating margins were at 24.7% versus 28.2% in 3QFY05 and 25.8% in 2QFY06. Operating margin on a YoY basis have been under pressure due to higher raw material cost (an increase of 100bp YoY) and a steep

rise in other expenses (of 220bp YoY). QoQ also, margins were lower on account of higher other expenditure (increase of 110bp). Other expenditure includes one-time forex losses on currency debt.

EBITDA MARGIN: UNDER PRESSURE



RAW MATERIAL COST: DECLINING SINCE PAST 3 QUARTERS



Source: Company/Motilal Oswal Securities

Standalone profit grew 28.6% in 3QFY06 – higher than EBITDA growth of 13%

BFL recorded a substantial increase in other income at Rs161m, mainly on account of interest earned on the idle GDR funds that the company raised. As a result of strong topline growth and higher other income, PAT was Rs533m, an increase of 29% YoY

Consolidated PAT — 17% higher than standalone

Total revenues grew 37% QoQ to Rs9.6b and PAT grew 2% QoQ to Rs626m. Consolidated PAT in 3QFY06 is 17% higher than standalone profits. On a consolidated basis, EBITDA margins are at 16.1% in 3QFY06 compared with 20.3% (2QFY06). For 9MFY06, EBITDA margins are at 18.6%, which is in line with our expectations.

CONSOLIDATED EARNINGS (RS M)

	FY05		FY06	
	3Q	9M	3Q	9M
Total Income	5,287	14,578	9,567	23,043
EBITDA	1,230	3,198	1,541	4,305
EBITDA Margins%	23.3	21.9	16.1	18.7
PAT	576	1,435	626	1,870
PAT Margin (%)	10.9	9.8	6.5	8.1

Source: Company/Motilal Oswal Securities

JV with FAW, China fully completes dual shore model

BFL announced its much-awaited China venture with FAW Corporation, the largest automotive player in China (estimated market share in excess of 30%). BFL will have a 52 % stake in the venture, which will make components for cars and trucks for the Chinese market. The venture — FAW Bharat Forge Changchun Ltd. — will have a factory located at Changchun in northern China with an annual forging capacity of 100,000 metric tons (20% of BFL's existing capacity) and an employee strength of 1,700. This reflects BFL's technological leadership and global market strength. The JV will enable BFL to become the largest forging components player in China.

The JV will raise BFL's total forging capacity to 600,000 MT

ANNUAL FORGING CAPACITY:FORGING CAPACITY (MT)

Country

India *	240,000
Europe	200,000
USA	60,000
China	100,000
Total	600,000

* India: Current capacity: 200,000MT, expansion 40,000MT

The Chinese deal is BFL's first overseas joint venture as compared to the earlier deals, where BFL had purchased

existing units outright (in Germany, USA and Sweden). BFL was able to acquire these units at inexpensive rates (0.2x sales) as several auto part units in western countries have been facing bankruptcy owing to high labor cost and unviable manufacturing expenses.

The rationale supporting BFL's new venture in China are (1) it is a low cost country and it makes sense to set up a new unit; (2) it is emerging as one of the largest countries in terms of automobile sales. Presently China accounts for a mere 5% of BFL's consolidated global revenues. If BFL wants to emerge as the largest global player, it would have had to establish a presence in China sooner or later.

ACQUISITION HISTORY

DATE	COMPANY	ACQUISITION (RS) AMOUNT	ANNUAL T/O (RS.)
Jan-04	CDP, Germany	1,680m	8.1b
Dec-04	CDP AT, Germany	360m	2.0b
Jun-05	Federal Forge, USA	396m	2.6b
Sep-05	Imatra Kilsta, Sweden	2,500m	5.8b
Dec-05	FAW Bharat Forge, China	N.A.	N.A.

Source: Company/Motilal Oswal Securities

Dual shore model helps BFL in new order wins

The Dual Shore Capability model is working well for BFL. The company is successfully leveraging its capability and has recently concluded long-term contracts with three global OEMs to supply machined power-train components.

Valuation and view

We remain positive on BFL's dual shore model and management's global vision. The company is close to reaching revenues of US\$1b by FY08. In fact, we believe it may hit this target earlier. The recent initiatives of the global technology center, its acquisitions and recently formed JV with FAW, China- make BFL a world leader in its class.

BFL remains a preferred vendor for several global OEMs and is the lowest cost producer with the highest technological capabilities – a combination which is difficult to beat. Hence, we remain extremely positive on its growth prospects in the future.

CONSOLIDATED EARNINGS				
PARTICULARS	2005	2006E	2007E	2008E
Cons. Sales	19,934	32,114	41,212	47,344
Cons. EBITDA	4,266	5,478	7,045	8,461
EBITDA margin (%)	21.4	17.1	17.1	17.9
Cons. Net Profit	2,010	2,923	3,868	4,625
Cons. EPS (Diluted)	10.2	11.8	15.6	18.7

Source: Company/Motilal Oswal Securities

BFL trades at a P/E of 25x FY07E and 20.9x FY08E on consolidated earnings. Given the bright prospects, high growth visibility and clear road map for future growth, we maintain a **Buy** on the stock.

Bharat Forge: an investment profile

Company description

Bharat Forge is the second largest forging manufacturer in the world. Its recent acquisitions has left the company only second to Thessian Krup. Primarily, focused on automobile forgings Bharat Forge has a near monopoly in the commercial vehicle forging segment in India. The company has substantial geographic distribution of sales as well.

Key investment arguments

- ✍ BFL's addressable market opportunity stands at US\$10b per annum and BFL is targeting a share of US\$1b by FY08, nearly twice its existing turnover. We believe BFL is well placed to more than double its existing 5% market share in three years and has a clear road map to achieve this.
- ✍ Forgings and casting by the mere nature of the manufacturing process are very popular outsourcing items.

Key investment risks

- ✍ Aggressive inorganic growth strategy might lead to increased debt levels or further equity dilution.

COMPARATIVE VALUATIONS

		BHARAT FORGE	TATA MOTORS
P/E (x)	FY06E	43.8	17.8
	FY07E	33.1	16.3
EPS Gr (%)	FY06E	36.8	11.7
	FY07E	32.4	9.6
ROE (%)	FY06E	35.0	27.9
	FY07E	32.5	25.8
EV/EBITDA (x)	FY06E	18.8	8.4
	FY07E	14.4	7.5

SHAREHOLDING PATTERN (%)

	DEC.05	SEP.05	DEC.04
Promoters	35.3	35.0	37.6
Domestic Institutions	12.5	12.7	13.9
FII's/FDI's	22.5	22.1	15.6
Others	29.7	30.2	32.9

Recent developments

- ✍ BFL announced its much-awaited China venture with FAW Corporation, the largest automotive player in China with an annual forging capacity of 100,000 metric tons (20% of BFL's existing capacity)

Valuation and view

- ✍ In FY06, we expect consolidated revenues of Rs.32b and a PAT of Rs2.9b, resulting in a fully diluted EPS of Rs11.8
- ✍ BFL trades at a P/E of 25x FY07E and 20.9x FY08E on diluted consolidated earnings of Rs15.6 and Rs18.7.
- ✍ Given the bright prospects, high growth visibility and clear road map for future growth, we maintain a **Buy** on the stock

Sector view

- ✍ Auto ancillary sector is witnessing strong demand from global OEMs attempting to offshore components and reduce costs.
- ✍ Forgings and casting due to environmental and health norms have been witnessing the strongest demand from global players.
- ✍ We maintain an overweight stance on the sector

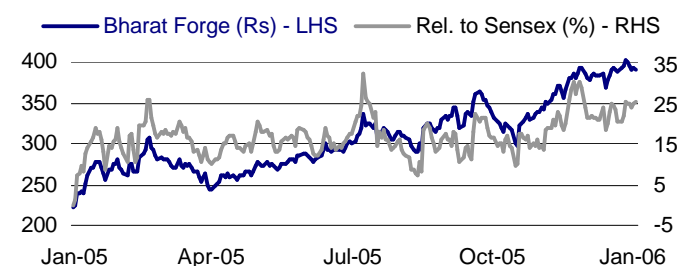
EPS: INQUIRE FORECAST VS CONSENSUS (RS)

	INQUIRE FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY06	11.8	11.4	3.5
FY07	15.6	14.9	4.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
392	450	14.8	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Net Sales	8,321	12,191	15,972	20,118	24,527
Change (%)	30.9	46.5	31.0	26.0	21.9
Total Income	8,321	12,191	15,972	20,118	24,527
Expenditure	5,919	8,916	11,915	14,928	18,088
Raw Material	3,181	5,242	7,139	8,852	10,792
% of Net Sales	38.2	43.0	44.7	44.0	44.0
Employee Cost	537	693	942	1,187	1,410
Other Mfg. Expenses	2,200	2,982	3,833	4,889	5,886
EBITDA	2,402	3,275	4,057	5,190	6,438
Change (%)	28.9	36.3	23.9	27.9	24.0
% of Net Sales	28.9	26.9	25.4	25.8	26.3
Depreciation	458	526	716	893	1,008
Interest & Finance Charges	324	342	516	434	414
Other Income	191	74	451	474	474
PBT	1,812	2,481	3,277	4,337	5,490
Tax	563	865	1,065	1,410	1,922
Effective Rate (%)	31.1	34.8	32.5	32.5	35.0
PAT	1,249	1,616	2,212	2,928	3,569
% of Net Sales	15.0	13.3	13.8	14.6	14.5
Change (%)	54.0	29.4	36.8	32.4	21.9

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
Equity Capital	377	396	396	396	396
Reserves	1,836	3,830	5,717	8,399	11,720
Net Worth	2,512	4,426	6,313	8,994	12,316
Deferred Tax	806	812	1,131	1,554	1,938
Loans	2,856	4,179	5,429	5,429	5,179
Capital Employed	6,173	9,416	12,873	15,977	19,433
Gross Fixed Assets	8,220	9,477	13,829	17,128	19,707
Less: Depreciation	3,708	4,213	4,929	5,823	6,833
Net Fixed Assets	4,512	5,264	8,900	11,304	12,874
Capital WIP	877	2,769	375	375	400
Investments	344	383	383	383	383
Curr.Assets, L & Adv.	5,228	7,848	12,661	13,728	16,863
Inventory	1,331	1,861	2,061	2,596	3,165
Sundry Debtors	1,001	1,431	1,638	2,063	2,516
Cash & Bank Balances	86	281	6,615	7,896	10,303
Loans & Advances	2,366	3,611	2,347	1,173	880
Current Liab. & Prov.	4,869	6,892	9,489	9,857	11,131
Creditors	1,865	1,939	4,259	4,280	5,218
Other Liabilities	126	404	424	487	512
Acceptances	1,389	1,975	1,975	1,975	1,975
Net Current Assets	360	956	3,172	3,871	5,732
Miscellaneous Expenditures	81	43	43	43	43
Application of Funds	6,174	9,416	12,873	15,977	19,433

E: MOST Estimates; Standalone

RATIOS					
Y/E MARCH	2004	2005	2006E	2007E	2008E
EPS	6.6	8.2	11.2	14.8	18.0
Diluted EPS			8.9	11.8	14.4
EPS Consolidated	-	10.2	14.8	19.6	23.4
Diluted EPS Cons.			11.8	15.6	18.7
Cash EPS	9.1	10.8	14.8	19.3	23.1
Book Value per Share	13.3	22.4	31.9	45.5	62.3
DPS	2.3	3.1	3.1	3.3	3.1
Payout %	38.3	38.1	28.0	22.0	17.0
Valuation (x)					
P/E (Diluted)	59.1	48.0	43.8	33.1	27.1
P/E Consolidated (Diluted)	-	38.6	33.2	25.0	20.9
Cash P/E	43.2	36.2	26.5	20.3	16.9
EV/EBITDA	31.9	24.8	18.8	14.4	11.2
EV/Sales	9.2	6.6	4.8	3.7	2.9
Price to Book Value	29.4	17.5	12.3	8.6	6.3
Dividend Yield (%)	0.6	0.8	0.8	0.8	0.8
Profitability Ratios (%)					
RoE	49.7	36.5	35.0	32.5	29.0
RoCE	34.6	30.0	29.5	29.9	30.4
Turnover Ratios					
Debtors (Days)	41	40	35	35	35
Asset Turnover (x)	1.3	1.3	1.2	1.3	1.3
Leverage Ratio					
Debt/Equity (x)	1.1	0.9	0.9	0.6	0.4

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2004	2005	2006E	2007E	2008E
OP/(Loss) before Tax	1,944	2,749	3,341	4,297	5,430
Interest/Div. Received	191	74	451	474	474
Depreciation & Amort.	458	526	716	893	1,008
Direct Taxes Paid	-537	-858	-745	-987	-1,537
(Inc)/Dec in Wkg. Capital	578	-363	4,118	581	546
CF from Op. Activity	2,634	2,127	7,881	5,259	5,921
(Inc)/Dec in FA+CWIP	-1,281	-3,170	-1,957	-3,298	-2,603
(Pur)/Sale of Invest.	-344	-40	0	0	0
CF from Inv. Activity	-1,625	-3,210	-1,957	-3,298	-2,603
Inc./(Dec) in Networth	27	913	295	399	361
Inc/(Dec) in Debt	-380	1,323	1,250	0	-250
Interest Paid	-324	-342	-516	-434	-414
Dividends Paid	-478	-616	-619	-645	-608
CF from Fin. Activity	-1,155	1,278	410	-680	-911
Inc/(Dec) in Cash	-146	195	6,333	1,281	2,407
Add: Beginning Balance	233	86	281	6,615	7,896
Closing Balance	87	281	6,615	7,896	10,303

N O T E S



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Bharat Forge

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|--|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |

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